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Commercial Mortgage REITs: Tax Considerations When Dealing with Distressed Mortgage Loans

By Kendal A. Sibley, George C. Howell, III, and Joshua R. Venne*

In this article, the authors describe issues a commercial mortgage real estate investment trust might face when a borrower is in distress.

High inflation and rising interest rates have already triggered some high profile defaults in the commercial real estate space. Layering on the glacial pace of "return-to-office" progress, commercial mortgage real estate investment trusts (REITs) may see more borrowers looking to renegotiate loans or even give back the keys. In addition to the typical tax issues that face a lender in a modification or foreclosure situation, REITs must also consider the impact of the modification or foreclosure on their REIT asset, income, and distribution tests. The following high level discussion describes issues a commercial mortgage REIT might face when a borrower is in distress. The tax and REIT results can be extremely fact dependent, so REITs should always consult with their tax advisors as soon as possible in the modification process.

CLO RESTRICTIONS

Many commercial mortgage REITs finance a portion of their assets through collateralized loan obligation (CLO) transactions. If a borrower is seeking a modification, the first step is to determine what modifications are permitted under the CLO documents. Different types of modifications require different consents and have different consequences under CLO documents, including potential changes in borrowing base, required paydowns, or required rating agency notification or consent. Even if the loan financed by the CLO is not itself being modified, creating additional subordinate debt could potentially raise CLO issues. Thus, in determining the possible paths for modification, the first step is to ascertain what CLO restrictions might apply to various alternatives.

"PLAIN VANILLA" MODIFICATION

If modification is permitted under the CLO documents, then the REIT must determine and consider the REIT and tax impacts of the potential modification.

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A "plain vanilla" modification, for purposes of this discussion, would include a modification that extends the term, capitalizes delinquent interest, forgives a portion of the principal balance, and/or changes the interest rate to another fixed or index-based rate. The modified instrument would not contain any contingent payments, equity features, or sharing in profits. No new money would be advanced.

REIT Treatment

Good news! Assuming that the REIT originated the loan or purchased it prior to distress, Revenue Procedure 2014-51 provides very favorable treatment for purposes of the REIT income and asset tests.[1] Under Revenue Procedure 2014-51, if the modification is either "occasioned by default," or the REIT reasonably believes that the pre-modified loan presented a significant risk of default and the modified loan presents a substantially reduced risk of default, then the REIT does not need to treat the modification as a new commitment to make or purchase a loan for purposes of the REIT tests. As a result, if the loan produced only qualifying income for purposes of the REIT gross income tests before the modification, it should continue to produce qualifying income after the modification. Also, under the Revenue Procedure, the modification would not cause a REIT prohibited transaction. Finally, for purposes of the asset tests applicable to REITs, the REIT can treat the loan as a real estate asset in an amount equal to the lesser of (A) the value of the loan, or (B) the greater of (i) the current value of the real property securing the loan, and (ii) the "loan value of the real property." Because the REIT need not treat the modification as a new commitment under the Revenue Procedure, the REIT would be able to continue to use the value of the real property at original origination (which should be higher than the principal balance of the loan) as "the loan value of the real property." As a result, if the pre-modified loan was a qualifying asset for purposes of the REIT asset tests, the modified loan should continue to be a qualifying asset.

Tax Treatment

As described above, in very general terms, if a REIT originated a loan in good times, then a later distress modification of the type described above effectively is ignored for purposes of applying the REIT income and asset tests. The modification nonetheless will have other tax consequences.

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[1] Revenue Procedure 2014-51 is also helpful for distressed loan purchases by a REIT. Treatment of distressed loan purchases is beyond the scope of this summary.

In general, if a modification is a "significant modification," then, for tax purposes, the holder is treated as exchanging the old pre-modified loan for the modified loan. There are detailed Treasury regulations on when a modification rises to the level of "significant." As a practical matter, any modification that provides meaningful relief to a distressed borrower will be "significant." The remainder of this discussion assumes that the modification is significant, such that it is treated as a debt-for-debt exchange for tax purposes.

If the borrower is a corporation and if the old loan and modified loan qualify as "securities," then the debt-for-debt exchange could qualify as a tax-deferred recapitalization under Section 368(a)(1)(E) of the Internal Revenue Code of 1986, as amended. "Securities" is not defined, but generally is thought to require a term of more than five years. REITs generally will face a special purpose limited liability company property owner as the named borrower. For purposes of determining whether the borrower is a corporation, the REIT must determine the first regarded tax entity that owns the borrower entity. If the debt-for-debt exchange qualifies as a recapitalization, then the REIT generally would not recognize gain or loss in connection with the modification (except to the extent of interest or original issue discount paid).

Many commercial real estate borrowers are not corporations, and many loans do not have terms of more than five years. For exchanges that do not qualify as recapitalizations, the REIT would recognize gain or loss on the deemed exchange equal to the difference between the "amount realized" and its tax basis in the pre-modified loan. The "amount realized" in a debt-for-debt exchange would be the "issue price" of the modified loan. The issue price will depend on whether the loan is considered to be "publicly traded." If the loan is not considered "publicly traded" and the interest rate is no lower than the applicable federal rate, then the issue price generally will be the principal balance of the loan. For a "publicly traded" loan, however, the issue price will be based on the fair market value of the loan. The bar for being treated as "publicly traded" is quite low. If an indicative price quote is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers) for a loan with an outstanding principal balance of more than $100 million, the loan would be treated as "publicly traded."

In a distress situation, as a practical matter, the issue price is likely to be lower if the loan is treated as publicly traded because the loan is likely to be trading below par. For example, if a REIT originated a loan for $101 and modifies the loan as a result of distress to extend the term for an additional two years with no change to the principal balance or interest rate, the "issue price" for a non-publicly traded loan generally would equal the principal balance ($101). In that case, the REIT would have a $0 loss as a result of the modification ($101

"issue price" of new debt minus $101 tax basis). If the same loan were publicly traded, the "issue price" would be whatever the fair market value of the loan is, which could be substantially less. For example, if the loan were trading at $60, the REIT could have a loss of $41 ($60 "issue price" of new debt minus $101 tax basis).

If the REIT recognizes a loss,[2] the loss could be ordinary, particularly if the REIT is treated as being in the trade or business of lending money.[3] If the REIT has a loss of more than $10 million, it should review the "reportable transaction" rules to determine whether reporting is required. In most cases, a loan originated by the REIT would not require reporting.

Under the Treasury regulations, a modification occurs when the parties enter into a binding agreement to change a term, even if the change is not immediately effective. If there are closing conditions that must be satisfied (for example, shareholder, regulatory, or senior creditor approval, or additional financing), the modification is not effective until the closing date when the conditions are satisfied. REITs negotiating modifications close to a year end should be mindful of this timing impact, particularly if the modification will generate a deductible loss.

To the extent that the "issue price" of the modified loan is lower than its principal balance, the modified loan will be treated as having been issued with original issue discount (OID), which the REIT will be required to accrue into income over time on a constant yield method.

MORE CREATIVE MODIFICATION

In some cases, a more complicated or creative modification may present the best possible return for a REIT. For example, a REIT would be loath to reduce principal if the borrower could sell the building for a gain in short order. As another example, a borrower may need additional funds to provide tenant improvements in an effort to improve occupancy rates and debt service coverage.

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[2] A REIT that originated a loan generally would expect a loss in a distress situation because its tax basis in the originated loan would be close to par. Buyers of distressed mortgage loans at discounted prices would have lower tax basis in the loans and could have unexpected gain on a modification, particularly if the loan is not publicly traded. Treatment of purchasers of distressed mortgage loans is beyond the scope of this discussion.

[3] The IRS has issued regulations in the past that would result in capital loss treatment even for entities in the trade or business of lending. The IRS withdrew those regulations in Announcement 2008-41, 2008-10 I.R.B. 943, and announced that it would continue to study the issue.

REIT Treatment

Protect the Treatment of the Existing Loan

Revenue Procedure 2014-51 as described above allows a REIT to use more favorable real property values for purposes of the REIT asset tests in distress modifications, but it does not override other REIT testing rules. For this reason, a REIT generally will benefit from documenting what this discussion will call more "creative" modifications separately from any "plain vanilla" modification of the distressed mortgage loan. For example, a REIT could enter into a modification of the type described in the section above with respect to its existing senior mortgage loan, and also enter into a separate instrument described in this section. If the modification of the existing mortgage loan satisfies Revenue Procedure 2014-51, then the REIT may be able to continue to hold the modified loan as a qualifying asset producing qualifying income. Any new instruments would be evaluated separately.

Contingent payments are one example of rights that could be documented in a new separate instrument, which may need to be held by a taxable REIT subsidiary. For purposes of the REIT gross income tests, interest on a mortgage loan fully secured by real property is qualifying income, provided that the amount of interest does not depend on the interest or profits of any person.[4] If any portion of the interest depends in whole or in part on the income or profits of any person (whether or not derived from property secured by the obligation), then the entire interest is disqualified, including any fixed rate portion. For this reason, REITs generally would not want to include contingent payments in a modified loan that could benefit from Revenue Procedure 2014-51.

Consider Whether to Use a Taxable REIT Subsidiary

A taxable REIT subsidiary is subject to entity level tax at regular corporate rates. A taxable REIT subsidiary can hold assets that would otherwise be nonqualifying assets or produce nonqualifying income if held by the REIT directly. A taxable REIT subsidiary can also hold assets that would produce gain subject to the 100% prohibited transaction tax.[5] No more than 20% of the REIT's total assets may consist of securities of taxable REIT subsidiaries. Dividends from taxable REIT subsidiaries are qualifying income for purposes of the 95% gross income test, but not the 75% gross income test. In a distress

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[4] If the contingent amount is based on rents received by the borrower that would be qualifying if received by a REIT, then such amounts are not excluded from qualifying interest.

[5] The taxable REIT subsidiary would be subject to tax at regular corporate rates on any gain, but would not be subject to the 100% prohibited transaction tax on the gain.

modification of a commercial mortgage loan, a REIT may find it beneficial to hold portions of the instruments created as a result of the modification in a taxable REIT.

One potential commercial mortgage loan modification is the separation of the existing principal into a senior portion that continues to be interest bearing and a B-note or "hope note" that is not interest bearing and pays only in the event of a property sale. Ideally, the senior portion could benefit from Revenue Procedure 2014-51 as described above. The new "hope note," however, must be analyzed separately.

A "hope note" has some similarities to a "shared appreciation mortgage." A shared appreciation mortgage is a mortgage where the lender shares in a percentage of the appreciation in the property that occurs after the date of origination of the mortgage.[6] A shared appreciation provision is a sharing in appreciation, not a sharing in total proceeds, so the economics may not match what the REIT desires to achieve with the "hope note." Even if a "hope note" could be viewed as a shared appreciation provision, for REIT purposes, shared appreciation provisions are subject to the same prohibited transaction tax rules as other sales of property. Thus, even if the economics work, where the business plan includes selling the property as soon as possible, there is a material risk that the REIT could be subject to the 100% prohibited transaction tax on shared appreciation gain. For this reason, a REIT may benefit from holding any "hope note" in a taxable REIT subsidiary.

A REIT may also advance new money in a distress modification. The first question with respect to new instruments will be whether they should be treated as debt or equity for tax purposes. Treatment as a debt instrument is determined under common law principles. For example, a debt instrument is expected to be paid in all circumstances regardless of the success of the borrower's business, and the return on a debt instrument is "debt-like," generally based on a reasonable fixed or index-based rate, and not based on the borrower's profits. This is a highly fact dependent determination, and the REIT's tax advisors would examine all of the facts to determine whether it was reasonable to treat any new instrument as debt for tax purposes.

If the REIT advances new money that can be treated as debt for tax purposes, then the new debt instrument would be evaluated for REIT purposes like any other loan purchased or originated by the REIT. As described above, to produce qualifying income, a loan must be fully secured by real property. Because

[6] It is not clear whether the treatment of shared appreciation mortgages under IRC § 856 would extend to mezzanine loans.

Revenue Procedure 2014-51 would not apply to the new debt instrument, the security for the new debt instrument would be measured as the current (distressed) real property value minus the amount of any senior debt. In a distress situation, there may not be sufficient real property value to conclude that the new debt would be a qualifying real estate asset for purposes of the REIT asset tests. However, all is not lost. If the REIT has capacity under its 75% asset test and 75% gross income test, the REIT might be able to hold the new debt instrument in the REIT as long as the new debt instrument either represents less than 10% of the borrower's capital stack or is eligible for an exception to the 10% value test.[7] If there is a portion of new funding that is expected to be repaid and a portion that is contingent, structuring the two pieces separately may maximize the amount that could be held outside of a taxable REIT subsidiary.

To optimize its recovery from a distressed mortgage loan, a REIT may want to hold an instrument that shares in a portion of the borrower's profits (from a sale or otherwise). It is possible that such an instrument could be treated like equity for purposes of the REIT testing requirements. If a REIT owns an equity interest in a non-corporate borrower, the REIT would be required to include in its REIT income and asset testing its proportionate share of the borrower's income and assets, based on the REIT's capital interest in the borrower. Although a REIT can hold an equity interest in real property and receive qualifying rents,[8] a REIT in a distress modification may not be able to negotiate (or desire to negotiate) sufficient contractual protections to conclude that income of the borrower would actually be qualifying. In addition, gain from sales of property would flow through an equity interest, which could expose the REIT to the 100% prohibited transaction tax. For these reasons, equity interests or profits participations created in a distress situation are often held in taxable REIT subsidiaries.[9]

Tax Treatment

The tax treatment of the modification of the existing loan generally would be the same as what was discussed above under "Plain Vanilla" Modifications.

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[7] If the REIT or its taxable REIT subsidiaries also own equity or profits participations in the borrower, the "straight debt" safe harbor may not be available.

[8] Equity interests held by the REIT are discussed in more detail below under the foreclosure section. REITs should note that there is no "related party interest" corollary to the "related party rent" restrictions.

[9] Special care should be taken in the event of an equity interest in a borrower operating a hotel or healthcare property as those activities cannot be conducted by a taxable REIT subsidiary.

The tax treatment of any new instrument would depend on the characteristics of the new instrument. Whether the REIT or taxable REIT subsidiary is required to take income into account could depend on whether there is any cash received or any expectation of ever receiving a return.

FORECLOSURE/DEED IN LIEU

In certain circumstances, foreclosure or deed in lieu of foreclosure may be the better route from a business perspective. If a commercial mortgage REIT is taking ownership of the collateral, ownership structures will impact REIT income and asset testing.

REIT Treatment

As is obvious by the large number of equity REITs, real property is a qualifying asset for REITs. Thus, it is possible that a commercial mortgage REIT may be able to foreclose[10] on collateral and hold the resulting asset for the production of rental income. REITs will need to analyze the assets comprising the collateral and the income streams from the property to ensure they are structured properly for purposes of the REIT asset and gross income tests.

Prior to foreclosure, if the REIT plans to hold the asset long-term, the REIT should conduct a REIT feasibility analysis of the collateral property. The feasibility analysis would consider items such as the value of real property versus personal property in the collateral, whether any of the leases at the property are based on the income or profits of the tenant, whether the property produces any operating income, what services are provided to the tenants, and what entities are providing tenant services. Depending on the results of the feasibility analysis, the REIT may need to add additional structuring, such as implementing a full Opco/Propco structure for a foreclosure of a hotel or adding a taxable REIT subsidiary to provide certain services to avoid impermissible tenant services income. REITs that have foreign investors that are sensitive to effectively connected income may choose to conduct the entire foreclosure in a taxable REIT subsidiary.

REITs may want to hold a property through a joint venture with an operator or may want to engage a property manager to operate a property. In either case, the operative documents can include restrictions on how the property is

[10] Unless the context indicates otherwise, this discussion uses "foreclose" and "foreclosure" to cover taking ownership of the collateral through a full foreclosure proceeding or through a deed in lieu of foreclosure.

operated to make sure that the income produced by the property remains qualifying for purposes of the REIT gross income tests.

If the REIT feasibility study indicates that the income from the property will not be qualifying, then a foreclosure property election may be prudent. A foreclosure property election is made on the REIT's tax return for the year in which the foreclosure took place.[11] If the election is made, income and gains from the foreclosure property are treated as qualifying income for purposes of the 75% gross income test, even if the income would otherwise be nonqualifying (e.g., income from operating a carousel or skating rink). The foreclosure property election lasts for three years and may be extended. If the election is made, nonqualifying income from foreclosure property is subject to tax at the highest corporate rate. Income that would otherwise be qualifying for the REIT is not subject to the foreclosure property tax. If a property produces only a small amount of nonqualifying income, the REIT may be able to manage the nonqualifying income in its 5% bad income bucket without making a foreclosure property election.

Tax Treatment[12]

Upon a deed in lieu of foreclosure, a REIT would have an ordinary bad debt deduction for the difference between its tax basis in the debt and the fair market value of the collateral transferred. For an actual foreclosure, the practical result is essentially the same, though there are two potential steps. If the REIT bids an amount at the foreclosure sale less than its tax basis in the loan, then it will have a bad debt deduction in the amount of the difference. If the amount bid in at the foreclosure sale is not the same as the fair market value of the property, the lender would also have gain or loss equal to the difference between the bid price and the property's fair market value. The amount bid in at the foreclosure sale is presumed to be the fair market value unless there is clear and convincing evidence to the contrary. In all cases, the REIT would take a fair market value tax basis in the foreclosed property.

CONCLUSION

Commercial mortgage REITs must navigate multiple constraints in designing an appropriate strategy for a distressed mortgage loan. In addition to the

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[11] A foreclosure property election is permitted for full foreclosures and deeds in lieu of foreclosure.

[12] The tax treatment of the borrower, which will vary depending on whether the debt is recourse or nonrecourse, is beyond the scope of this discussion.

overall economics, REITs must comply with CLO transaction document limitations and must structure the modification or foreclosure in a manner consistent with maintaining their status as a REIT. There are a number of structuring possibilities available that can be considered when a distress situation arises, but each will need to be evaluated based on the particular facts to achieve the desired result and avoid surprises.